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No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN H. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 21–37) is not officially reported. The opinion of the Circuit Court of Appeals (R. 173–176) is reported at 142 F. 2d 818.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 25, 1944. (R. 176.) The petition for writ of certiorari was filed on August 18, 1944, and granted on October 16, 1944. (R. 177.) The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, upon the receipt of stock purchased under an option granted him in an earlier year as compensation for personal services, the respondent realized taxable income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code, in the amount of the excess of the fair market value of the stock at the time of acquisition over the option price.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

Section 22 (a) of the Internal Revenue Code (26 U. S. C., Sec. 22), applicable to 1939, is identical.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 22 (a)–1. *What included in gross income.*—
>
> * * * * * *
>
> If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stocks as to which see article 22 (a)–8.
>
> * * * * * *

Section 19.22 (a)–1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, is identical.

STATEMENT

The following facts were found by the Tax Court (R. 22–30):

The respondent had for many years been employed by the Western Cooperage Company (hereinafter called Western), and at the time of the hearing before the Tax Court was its general manager. (R. 22.) At the request of a bondholders' committee of the Hawley Pulp and Paper Company (hereinafter called Hawley), which had been in financial difficulties before 1933, Western took over the management of that corporation. (R. 22–23.) The respondent was personally active in the reorganization of Hawley, which took place in 1934. (R. 23.) He interviewed many of the holders of Hawley securities and obtained the deposit of a substantial amount of securities under the reorganization plan. (R. 23.) Under the plan adopted, Western was to continue, at its option, to manage Hawley so long as it was not in default under the plan, which provided that the management, under Western, was to retire certain amounts of indebtedness each year. (R. 23.)

Western was to be compensated for management services by receiving from a depositary of Hawley stock, after the retirement of $1,400,000 of Hawley's total indebtedness of $2,790,150, a

proportion of the total number of shares deposited equal to the proportion of the total indebtedness retired. (R. 23.) Thereafter the remaining shares were to be delivered to Western on the same basis. (R. 23–24.) Of the Hawley common stock 174,378 shares were deposited pursuant to the reorganization plan. (R. 24.)

To reward respondent for the services which he had rendered in connection with the reorganization, Western's president and general manager granted him an oral option in December 1934. (R. 24.) On the advice of counsel, Western in May 1937 adopted a corporate resolution authorizing the execution of a formal written option embodying the terms of the oral option. (R. 24.) The resolution stated that the option was granted to the respondent (R. 24)—

> in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan * * *.

The written option executed pursuant to the resolution was dated as of December 10, 1934, and contained a similar recitation of the consideration for which it was given. (R. 24–25.) According to the terms of the option so granted, respondent was entitled to purchase, on or before January 1, 1940, at a price of $7,437.70, the right to receive

all Hawley common stock to which Western might become entitled in excess of 100,001 shares. (R. 25–26.) The option provided that if by reason of management defaults under the plan of reorganization Western should be entitled to receive only a portion of the deposited Hawley common stock, Western would, upon exercise of the option, file notice with the depositary that it had sold its right to receive 74,377 shares, and would order the depositary to deliver to respondent four shares for each six shares delivered to Western until all but 7,710 of the shares were delivered, and then to deliver this balance to the respondent. (R. 26–27.)

The price set in the option was not less than the market value of the price of the Hawley common stock at the time the oral option was granted. (R. 24, 27–28.)

On or before March 18, 1938, Western reduced the outstanding indebtedness of Hawley by $1,409,-720. (R. 27.) Respondent exercised his option and made payment by check dated March 21, 1938. (R. 27.) By an order dated March 18, 1938, Western directed the depositary to deliver 50,939½ shares of Hawley common stock to itself, and 33,759 shares to respondent, which he received on the following day. (R. 28.) From time to time in 1939 respondent received additional shares of Hawley common stock in the total number of 12,374. (R. 28.)

Respondent did not report any income for the year 1934 on account of the receipt of the option. (R. 28.) The excess of the fair market value of the stock received over the option price was $81,-021.60 in the year 1938, and $71,663.98 in the year 1939. (R. 29.) The Commissioner determined that such amounts constituted taxable income to the respondent in the respective years. The Tax Court sustained this determination on the ground that the amounts represented compensation received for personal services. (R. 21-37.) The court below reversed. (R. 176.)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred in holding that the respondent did not receive taxable income in the amount of the excess of the market value of the stock when received over the option price, and in reversing the decision of the Tax Court.

SUMMARY OF ARGUMENT

Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code includes within gross income, "gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid". The applicable Treasury Regulations require that where property is transferred by an employer to an employee for an amount substantially less than its fair market value, the employee shall include the difference in his gross income to

the extent that it is in the nature of compensation for services rendered, regardless of whether the transfer is in the form of a sale or exchange.

In the present case the Commissioner and the Tax Court determined that the excess of the market value of the Hawley stock when received over the option price was paid as compensation to the respondent, and accordingly included it in his gross income for the respective years of receipt. The Circuit Court of Appeals took a different view of the facts, and held that only the giving of the option was in the nature of compensation. The court erred in holding that there was no finding by the Tax Court, and no basis for a finding, that the option was intended to enable the respondent to make a bargain purchase. The Tax Court expressly found that the option was given as compensation for services, and that the option price was not less than the market value of the Hawley stock. Accordingly, the only method by which the option could serve as a device for remunerating the respondent would be through exercising it at a time when the value of the Hawley stock exceeded the option price. Thus, implicit in the Tax Court's decision is a finding that the option was intended to afford respondent an opportunity for a bargain purchase.

Further support for such a finding is found in the fact that Western would be unable to deliver

the Hawley stock upon the exercise of the option except under circumstances where the Hawley stock would be a bargain at the option price. Western would not receive the Hawley stock unless through its management the financial position of Hawley had improved, and such improvement would automatically bring about an increase in the value of the Hawley stock. Moreover, the Hawley stock, if acquired by Western as a result of its good management, would represent compensation to Western; and the option was but a means of sharing future earnings with respondent. The increase in value of the Hawley stock was not due to fortuitous circumstances beyond the control of the employer, and it is not true, as assumed by the court below, that the employer gave respondent a bare option.

ARGUMENT

UPON THE RECEIPT OF STOCK UNDER AN OPTION GRANTED TO HIM BY HIS EMPLOYER IN AN EARLIER YEAR AS COMPENSATION FOR PERSONAL SERVICES, THE RESPONDENT REALIZED TAXABLE INCOME WITHIN THE MEANING OF SECTION 22 (a) OF THE REVENUE ACT OF 1938 AND OF THE INTERNAL REVENUE CODE, IN THE AMOUNT OF THE EXCESS OF THE FAIR MARKET VALUE OF THE STOCK AT THE TIME OF RECEIPT OVER THE OPTION PRICE

This case turns on the application of Section 22 (a) of the Revenue Act of 1938 and of the

Internal Revenue Code, *supra,* which defines "gross income" as including—

> gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid * * *

The applicable Treasury Regulations (Article 22 (a)–1 of Treasury Regulations 101; Article 19.22 (a)–1 of Treasury Regulations 103), *supra,* provide:

> If property is transferred by * * * an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such * * * employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered * * *

The express words of the statute make the form of payment immaterial if, as a matter of fact, it is given as compensation for personal services. While the Regulations contain no further definition of compensation, there is a strong presumption that all gains flowing from the employer-employee relationship are in the nature of

compensation.[1] This may not always be true so far as bargain purchases are concerned. Conceivably such a bargain may occur where an employer can find no other buyer in a stagnant market, or even where the sole purpose is to ensure the employee's unflagging loyalty by giving him a stake in the employer's business.[2] If as a matter of fact, however, a transaction constitutes payment of compensation to the employee, its tax

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[1] See 54 Harv. L. Rev. 510, 511 (1941). From 1923 until the promulgation in 1939 of T. D. 4879, 1939–1 Cum. Bull. 159, the governing Treasury Regulations contained provisions substantially identical with the following provision of Article 22 (a)–1 of Treasury Regulations 94, promulgated under the Revenue Act of 1936:

"If property is transferred by * * * an employer to an employee, for an amount substantially less than its fair market value, such * * * employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value."

T. D. 3435, II–1 Cum. Bull. 50 (1923); Art. 31 of Treasury Regulations 65 and 69; Article 51 of Treasury Regulations 74 and 77; Article 22 (a)–1 of Treasury Regulations 86. This provision and the corresponding provision in Article 22 (a)–1 of Regulations 86 were amended by T. D. 4879, *supra*, to make them expressly state that such difference should be included "to the extent that such difference is in the nature of compensation for services rendered," as provided in the Regulations quoted in the text, and in subsequent Regulations (Sec. 29.22 (a)–1 of Treasury Regulations 111.) The effect of this amendment was to conform the Regulations to the course of judicial decisions. Cf. *White* v. *Winchester Club*, 315 U. S. 32.

[2] Cf., e. g., *Geeseman* v. *Commissioner*, 38 B. T. A. 258; *Adams* v. *Commissioner*, 39 B. T. A. 3[illegible]7.

consequences cannot be avoided by casting it in the form of a sale. *Connolly's Estate* v. *Commissioner,* 135 F. 2d 64 (C. C. A. 6th); *Erskine* v. *Commissioner,* 26 B. T. A. 147; *Epsen* v. *Commissioner,* 44 B. T. A. 322; cf. *Palmer* v. *Commissioner,* 302 U. S. 63, 69; *Phelps* v. *Commissioner,* 54 F. 2d 289 (C. C. A. 7th), certiorari denied, 285 U. S. 558; *Timberlake* v. *Commissioner,* 132 F. 2d 259 (C. C. A. 4th).[3] The amount received as compensation must be included in income of the year of receipt, and will be added to the basis of the property in computing gain or loss on subsequent sale, at least if it is actually returned by the taxpayer as gross income of the year of receipt. *Helvering* v. *Salvage,* 297 U. S. 106, affirming 76 F. 2d 112 (C. C. A. 2d); *Robinson* v. *Commissioner,* 59 F. 2d 1008 (C. C. A. 6th); Sec. 19.22 (a)-1 of Treasury Regulations 103; cf. *Larkin* v. *United States,* 78 F. 2d 951 (C. C. A. 8th); *Commissioner* v. *Farren,* 82 F. 2d 141 (C. C. A. 10th), certiorari granted, 298 U. S. 653, dismissed, 299 U. S. 617.

Where receipt of property from the employer is held not to constitute the payment of compensa-

[3] For the wide variety of plans for sale of an employer's assets to an employee, see Washington, Corporate Executives' Compensation (1942); Bastedo, Taxing Employees on Stock "Purchases," 41 Col. L. Rev. 239 (1941); Baker, Stock Options for Executives, 19 Harv. Bus. Rev. 106 (1940). Employers have not infrequently revised purchase plans to restore or increase their advantages to the employee. See, e. g., *Bothwell* v. *Commissioner,* 77 F. 2d 35 (C. C. A. 10th); *Evans* v. *Commissioner,* 38 B. T. A. 1406.

tion, the employee may be taxed only at the relatively lower capital gain rates on disposition of the property; and he may indeed escape all tax by postponing disposition to a year when, by reason of independent losses, his gain will not result in any taxable income. Section 117 of the Revenue Act of 1938 and of the Internal Revenue Code. The problem of determining whether particular dealings in property between employers and their employees give rise to taxable income has been a troublesome one for a quarter of a century, and has become very serious with the increases in taxation resulting from the war. While Congress has from time to time made special statutory provisions dealing with the tax aspects of transactions involving the receipt of compensation for personal services, the present case does not fall within any such provision.[4]

[4] Section 165 of the Revenue Act of 1938 and of the Internal Revenue Code, which provides for special treatment of "employees' trusts", does not apply to the present case since no such trust is involved.

The first provision relating to employees' trusts found in the Revenue Acts is Section 219 (f) of the Revenue Act of 1921, c. 136, 42 Stat. 227, providing that a trust created by an employer as part of a stock bonus or profit-sharing plan for the exclusive benefit of his employees should not be taxable as a trust, but that "the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him". This was continued as Section 219 (f) of the Revenue Act of 1924, c. 234, 43 Stat. 253; and of the Revenue Act of 1926, c. 27, 44 Stat. 9. It was changed in

In determining whether a particular transaction involves the payment of compensation for personal services, the decisive factor is that of intention. *Bogardus* v. *Commissioner*, 302 U. S. 34; *Levey* v. *Helvering*, 68 F. 2d 401 (App. D. C.); *Mason* v.

Section 165 of the Revenue Act of 1928, c. 852, 45 Stat. 791, so that upon distribution to the beneficiary "there should be taxed to him as compensation the amount contributed by the employer toward the purchase of the stock, all cash dividends on the stock, any interest paid to the employee, and any other income received by him, but that any appreciation in the value of the stock over the cost to the trustee should not be taxed unless and until the gain is realized." H. Rep. No. 2, 70th Cong., 1st Sess., p. 22 (1939–1 Cum. Bull. (Part 2) 384, 398–399). As so altered this provision was reenacted as Section 165 of the Revenue Act of 1932, c. 209, 47 Stat. 169; of the Revenue Act of 1934, c. 277, 48 Stat. 680; and of the Revenue Act of 1936, c. 690, 49 Stat. 1648. Section 165 of the Revenue Act of 1938 limited its application to cases where it was impossible before satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus to be used otherwise than for the exclusive benefit of the employees. The provision as so altered was carried into Section 165 of the Internal Revenue Code. Section 162 of the Revenue Act of 1942, c. 619, 56 Stat. 798, enacted in its stead a more restrictive and detailed statutory system. See S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 136–138.

Section 220 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862, added to the Internal Revenue Code, Section 107, which granted relief in cases where there was received in one year at least 95% of the payment for personal services extending over a period of five years or more. This does not apply to the present case for the reason, among others, that less than 95% of the compensation was received in 1939, the first year to which it applies.

Commissioner, 125 F. 2d 540 (C. C. A. 6th), certiorari denied, 317 U. S. 657; cf. *Palmer* v. *Commissioner, supra,* p. 70. This is, of course, a question of fact. Much of the inconsistency and confusion in the cases has resulted from the failure of appellate courts to accept decisions by the triers of fact on the issue of intention, even where supported by substantial evidence.[5] In some cases the appellate courts have found, upon their own appraisal of the evidence, that no part of the transaction was intended to confer compensation upon the employee; in others, of which the case at bar is typical, they have undertaken to split an integrated transaction into parts, and have held that only one part, such as the giving of a bare oral option, could have been intended as compensation. Whatever may have been the propriety of such broad appellate review under the decision in *Bogardus* v. *Commissioner, supra* (see *Hawke* v. *Commissioner,* 109 F. 2d 946, 950 (C. C. A. 9th), certiorari denied, 311 U. S. 657), it is no longer permissible since the overruling of the *Bogardus* decision *pro tanto* by *Dobson* v. *Commissioner,*

[5] See, e. g., *Omaha Nat. Bank.* v. *Commissioner,* 75 F. 2d 434 (C. C. A. 8th); *Rossheim* v. *Commissioner,* 92 F. 2d 247 (C. C. A. 3rd); *Hawke* v. *Commissioner,* 109 F. 2d 946 (C. C. A. 9th), certiorari denied, 311 U. S. 657.

Appellate decisions have in turn had their influence on the Board of Tax Appeals and the Tax Court. See e. g., *Evans* v. *Commissioner,* 38 B. T. A. 1406, 1413. Cf. *Commissioner* v. *Heininger,* 320 U. S. 467.

320 U. S. 489, 494, rehearing denied, 321 U. S. 231. The *Dobson* case establishes beyond question that these are matters of fact not reviewable if based on substantial evidence. See also, *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37; *Palmer* v. *Commissioner,* 302 U. S. 63; *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, rehearing denied, 305 U. S. 669; *Colorado Bank* v. *Commissioner,* 305 U. S. 23; *Helvering* v. *Lazarus & Co.,* 308 U. S. 252; *Wilmington Co.* v. *Helvering,* 316 U. S. 164; *Commissioner* v. *Heininger,* 320 U. S. 467; *McDonald* v. *Commissioner,* decided by this Court, November 20, 1944; *Commissioner* v. *Scottish American Inv. Co.,* decided by this Court, December 4, 1944.

The court below reversed the decision of the Tax Court on the ground that it had not found, and could not have found upon the evidence, that the option was intended to enable the respondent to make a bargain purchase. In the view of the facts taken by the court below, only the bare option could be regarded as having been given for the purpose of compensating the respondent; and, since that had no value, the respondent could not have received any compensation. (R. 174–175.) The Tax Court, on the other hand, regarded the giving of the option as but one part of an integrated transaction culminating in the payment of compensation to the respondent by deliveries of stock in 1938 and 1939. (R. 21–37.) The correctness of this view does not depend upon

imputation of bad faith or evasive motives;[6] it is simply a permissible construction of a transaction which might have been entered into solely for business purposes without regard to tax consequences.

We believe that the Tax Court in effect found that the option was intended to enable the respondent to make a bargain purchase, and that the evidence supported such finding. At the time of the reorganization, Hawley was in default on bond and note indebtedness totalling $2,790,150. (R. 23, 47, 52.) Western, respondent's employer, held about $27,000 of Hawley bonds. (R. 44.) Investigations of Hawley by committees representing its bondholders resulted in a committee recommendation that Hawley be reorganized under Section 77B of the Bankruptcy Act, and that Western assume the management of Hawley. (R. 46.) Western at first refused to undertake the management on the ground that its financial interest was insufficient to make it worth-while, but eventually did so in 1932 after reaching an understanding with other holders of Hawley securities as to compensation for its management services. (R. 46–48.) Under the plan adopted and

[6] While there were some indications in earlier days that bad faith must be found if a bargain purchase was to be held to have constituted the receipt of income (e. g., *Bradley* v. *Commissioner*, 1 B. T. A. 111, 118), it is now well settled that such a finding is unnecessary, and that the only inquiry is to the substance of the transaction. See cases cited in footnote 11, *infra*.

approved by the District Court in the reorganization case, not less than 85% of the common stock and second preferred stock of Hawley were to be deposited (R. 65), and the outstanding indebtedness was to be preserved without reduction in principal amount. (R. 56–58.) One of the seven directors was to be nominated by the committee for the second preferred and common stockholders in Hawley. (R. 55.) Western was given the right to discontinue its management of Hawley at its own option (R. 68), but was entitled to continue in management so long as it complied with numerous requirements laid down in the plan of reorganization. (R. 59–69.) As the sole compensation for its services (R. 124), Western was to receive, after retiring $1,400,000 of par value of Hawley's outstanding indebtedness, a proportion of the total number of shares deposited equal to the proportion of the total indebtedness retired; and upon retirement of additional amounts of indebtedness it was to receive annually additional amounts of the deposited stock in the same proportion. (R. 23, 65–66.) There were deposited, pursuant to the plan, 174,378 of the 200,000 outstanding shares of Hawley common stock. (R. 24, 127.)

In December of 1934, on the day of confirmation of the reorganization plan by the District Court, the president and general manager of Western gave the respondent an oral option to

purchase from Western its contingent rights in a portion of the deposited Hawley shares. (R. 24, 74, 77, 119). The purpose was to compensate the respondent for his services in connection with the reorganization (R. 24–25). In the respondent's own words (R. 74)—

> * * * he [the president and general manager of Western] made a promise to me, by saying that he wanted to reward my services * * * we made an option whereby he would reward me, made an agreement he would reward me for such services.

The oral option was ratified by formal corporate action in 1937, which expressed the same purpose. (R. 24–25.)

A witness for the respondent testified in the Tax Court that on the date when the respondent obtained the oral option Hawley's first mortgage bonds, secured by all its properties (R. 92), were selling at not to exceed $30 per hundred. (R. 119.) The only transfer of Hawley common stock known to the witness had been at 5 cents a share, and in his opinion the market price of the stock at the time was less than 10 cents a share. (R. 119.) The respondent himself testified that although the purpose of the option was to compensate him for his services (R. 74) the option "probably set a price that we felt was in excess of the market," and that if he could have sold the option at all

it would have been for a "negligible amount" (R. 107).

That the price set in the option on Western's contingent right to receive Hawley shares was no less than the market price of the shares themselves at the time the option was granted, and that the option itself was then substantially worthless, strongly indicate that the payment of compensation was intended to be the delivery of the stock, and not the conferring of the option itself. Cf. *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481, 499; *Connolly's Estate* v. *Commissioner, supra.* As the respondent himself testified, the option was a promise that he would be compensated; it was not in itself compensation. The gist of the option was that respondent would be paid only if Western should be paid; and that respondent would be given more than five years within which to decide whether to make Western's contingent promise binding by paying the option price. In this connection it is noteworthy that respondent did not report receipt of the option as income in 1934. (R. 28.)

Since the only way in which the option could serve to remunerate the respondent would be through exercising it at a time when the value of the Hawley stock exceeded the option price, the Tax Court's finding that there was a purpose to compensate the respondent is equivalent to a finding that there was an intention to afford him an opportunity for a bargain purchase. The case

is therefore specifically covered by the Treasury Regulations.

Further support for the finding that Western intended to enable the respondent to make a bargain purchase is furnished by the fact that Western would be unable to deliver the Hawley stock upon the exercise of the option except under circumstances where the Hawley stock would be a bargain at the option price. Western would not receive the Hawley stock unless through its management the financial position of Hawley had improved, and such improvement would automatically bring about an increase in the value of the Hawley stock. Moreover, the Hawley stock, if acquired by Western as a result of its good management, would represent compensation to Western; and the option was but a means of sharing future earnings with respondent. Thus the increase in value of the Hawley stock was not due to fortuitous circumstances beyond the control of the employer, and it is not true, as assumed by the court below, that the employer gave a bare option.

The Commissioner's determination must be sustained if the Tax Court made no "clear-cut mistake of law" in finding that the purpose and effect of the entire transaction was to pay the respondent compensation for his services by the delivery of the stock. *Dobson* v. *Commissioner, supra,* p. 502. From acceptance of the Tax Court's finding it will follow that the "normal rule" that income

is not realized by a bargain purchase must give way to the express words of Section 22 (a), requiring that there be included in gross income, compensation for personal services "in whatever form paid". It is of no moment that the services were rendered in a year prior to the year in which payment was received. *Lucas* v. *Ox Fibre Brush Co.*, 281 U. S. 115. The governing Treasury Regulations providing that where property is transferred by an employer to an employee for an amount substantially less than its fair market value, the employee shall include the difference in his gross income to the extent that it is in the nature of compensation for services, express well settled principles, are of long standing,[7] and must be deemed to have Congressional approval.[8]

The Circuit Court of Appeals erred in regarding the giving of the oral option in 1934 as the only time when income might possibly have been received;[9] for, as the Commissioner and the Tax Court have determined, the respondent received income only when, after exercising the option, he received the Hawley stock in 1938 and 1939. Where an option is a means for paying compensation for personal services, income is not usually

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[7] See footnote 1, *supra*.

[8] *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Helvering* v. *Reynolds Co.*, 306 U. S. 110, 115, 117; *Helvering* v. *Winmill*, 305 U. S. 79, 83.

[9] We find it unnecessary to rely on the apparent invalidity of the oral option until ratification by formal corporate action in 1937. (R. 115.)

received before the option is exercised. The employer's promise to transfer property expressed in the option is usually no more intended to be compensation for the employee's services than is the employer's promise to pay money wages or salary. Cf. *Shuster* v. *Helvering*, 121 F. 2d 643 (C. C. A. 2d). Neither promise is regarded as being, in itself, compensation; and it is intended that the employee wait for his compensation until he has rendered further performance. Until then, and until the employer makes the agreed return performance, the option is but a contingent promise which, under settled general principles,[10] has no immediate tax consequences for the employee, whether he returns his income according to the cash or the

[10] *Lucas* v. *North Texas Lumber Co.*, 281 U. S. 11. See also *Lucas* v. *American Code Co.*, 280 U. S. 445; *North American Oil* v. *Burnet*, 286 U. S. 417; *Brown* v. *Helvering*, 291 U. S. 193; *Dixie Pine Co.* v. *Commissioner*, 320 U. S. 516; *Security Mills Co.* v. *Commissioner*, 321 U. S. 281. In *Palmer* v. *Commissioner*, *supra*, it was stated (302 U. S. 71)—

"The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. Cf. *Miles* v. *Safe Deposit & T. Co.*, 259 U. S. 247; *Helvering* v. *San Joaquin Co.*, 297 U. S. 496; * * *. They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise."

accrual method of accounting.[11] This is not to say that compensation can never be received in the form of an option to buy property from the employer, as where the employee is given a valuable option which is intended to constitute in itself the compensation. In such circumstances it would not be possible to postpone the receipt of income to a later year by refraining from exercising it. The express words of Section 22 (a), and the regard for substance rather than form which has consistently characterized the decisions of this

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[11] *Connolly's Estate* v. *Commissioner*, *supra*; *Olson* v. *Commissioner*, 67 F. 2d 726 (C. C. A. 7th), certiorari denied, 292 U. S. 637; *Hawke* v. *Commissioner*, *supra*; *Mason* v. *Commissioner*, *supra*; *Haberman* v. *Commissioner*, 79 F. 2d 995 (C. C. A. 2d), affirming 31 B. T. A. 75; *Lister* v. *Commissioner*, 3 B. T. A. 475; *Erskine* v. *Commissioner*, *supra*; *Kingsbury* v. *Commissioner*, 31 B. T. A. 1126; *Estate of Hessian* v. *Commissioner*, decided April 29, 1943 (1943 P-H T. C. Memorandum Decisions, par. 43,203). See *Springford* v. *Commissioner*, 41 B. T. A. 1001, 1007. Cf. *Schaefer* v. *Bowers*, 50 F. 2d 689 (C. C. A. 2d), certiorari denied, 284 U. S. 668; *Omaha National Bank* v. *Commissioner*, 75 F. 2d 434 (C. C. A. 8th); Washington, Corporate Executives' Compensation (1942), pp. 88 *et seq.*

See also the following cases concerning the right of the employer to take a deduction for compensation paid: *Alger-Sullivan Lumber Co.* v. *Commissioner*, 57 F. 2d 3 (C. C. A. 5th); *Indianapolis Glove Co.* v. *United States*, 96 F. 2d 816 (C. C. A. 7th); *International F. Corp.* v. *Commissioner*, 135 F. 2d 310 (C. C. A. 2d), affirming 45 B. T. A. 716; *Helvering* v. *Commercial Investment Trust Corp.*, 74 F. 2d 1015 (C. C. A. 2d), affirming 28 B. T. A. 143; *Hudson Motor Car Co.* v. *United States*, 3 F. Supp. 834 (C. Cls.); *Commissioner* v. *Texas Pipe Line Co.*, 87 F. 2d 662 (C. C. A. 3rd).

Court,[12] would require that in such a case the value of the option be included in gross income of the employee for the year of receipt. Cf., e. g., *Andrews* v. *Commissioner*, 135 F. 2d 314 (C. C. A. 2d) certiorari denied, 320 U. S. 748. See further, *Helvering* v. *San Joaquin Co.*, 297 U. S. 496, 498, rehearing denied, 297 U. S. 728. While we do not contend for a rule that would invite such wholesale attempts at tax avoidance as would an inflexible rule that taxable compensation cannot possibly be given in the form of an option, it must be recognized that in most cases, as in the present, the giving of the option is but an initial step in an inchoate transaction which will not culminate in the payment of compensation until a later time. In any particular case the question is one of fact as to which the determination of the Tax Court should be accepted as final if supported by substantial evidence.

The excess of the value of the property received over the option price normally constitutes income to the employee on exercise of the option, since the property is then actually delivered or unconditionally subjected to his control.[13] The present case is exceptional, however, in that the option

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[12] See, e. g., *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716; *Lucas* v. *Earl*, 281 U. S. 111; *Gregory* v. *Helvering*, 293 U. S. 465; *Douglas* v. *Willcuts*, 296 U. S. 1; *Higgins* v. *Smith*, 308 U. S. 473; *Helvering* v. *Clifford*, 309 U. S. 331; *Helvering* v. *Bruun*, 309 U. S. 461; *Helvering* v. *Horst*, 311 U. S. 112.

[13] See footnote 11, *supra*.

consisted only of a promise by Western to surrender to the respondent its *contingent* right to receive a portion of the Hawley shares. Western's right under the reorganization plan to receive the shares which were delivered to respondent in 1938 had become fixed and certain very shortly before the exercise of the option, and those shares were delivered by the depositary to the respondent almost immediately after he exercised the option. (R. 27–28, 106.) While the excess value of these shares was therefore properly included in respondent's gross income for the year 1938, the excess value of the shares received in 1939 could not have been included in his gross income of 1938. Western's right, and accordingly respondent's right, to receive the shares delivered to him in 1939 did not become fixed until "a day or two" before the respective times of delivery. (R. 27–28, 65–66, 106–107.) Even if the taxpayer had been on the accrual basis, the excess value of those shares would not have constituted income to him until the conditions upon his right to receive them had been fulfilled.[14]

[14] See footnotes 10 and 11, *supra*. Whether the respondent reported income according to the cash or accrual method of accounting does not appear from the record. Since the respondent had the burden of proof that the Commissioner's determination was erroneous (*Welch* v. *Helvering*, 290 U. S. 111, 115), it may not be assumed in respondent's favor that he employed the accrual method, if the method employed be thought a material factor. While we think that it clearly is not a material factor, it may be noted that on facts like those of the present case the excess of the value of the

The entire excess of the fair market value of the Hawley stock at the times of receipt over the option price was properly included in respondent's gross income of the respective years. As the Tax Court and the Commissioner have determined, the entire excess was paid as compensation for the respondent's personal services. That amount having been paid as compensation, it follows that it must be included in the respondent's gross income of the years of receipt. It is of no consequence in this connection that the form of payment was fulfillment of a promise contained in an option, or that the market price of the Hawley stock was no higher at the time the option was granted than the price set in the option. The statute makes the incidence of the tax turn upon the fact of payment of compensation without regard to intermediate promises, and plainly rejects the suggestion that its operation may be affected by the fortuitous circumstances of the presence or absence of a spread between the option price and the market price when the option was granted years earlier.

Palmer v. *Commissioner*, 302 U. S. 63, held that the sale of corporate assets to stockholders pursuant to rights which had been distributed to them was not a means for the distribution of

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stock received over the option price would very plainly have been includible as income to a taxpayer employing the cash method of accounting only upon receipt of the stock. *Avery* v. *Commissioner*, 292 U. S. 210.

dividends. The Court recognized, however, that in a case involving different facts the result might be different. In the *Palmer* case, however, the Board of Tax Appeals had found that the corporation which issued the rights had "no intention to distribute any of its earnings to stockholders and that the transaction was what it purported to be on its face—a sale to stockholders of part of the corporate assets." This Court accepted these findings, and stated the issue to be whether a transaction is taken out of the category of sales and placed in that of dividends solely because the stock which was the subject of the rights had increased in value after the rights were issued. (302 U. S. at 67, 70.) In the case at bar, however, the Tax Court found that the option was issued pursuant to an intention to compensate the taxpayer, and that the increase in value of the Hawley stock was not fortuitous but was due to the efforts of the corporation which issued the option.

Moreover, the *Palmer* case was an attempt to fit the distribution into the restrictive statutory definition of a dividend. In this case there is no similar restrictive provision. The statute involved in the *Palmer* case was Section 115 (a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, which defined a dividend as a distribution by a corporation of its earnings and profits. This Court held that "it is at least necessary to make some showing that the transaction is in purpose or effect

used as an implement for the distribution of corporate earnings to stockholders." (302 U. S., p. 70). Here the taxing statute reaches compensation "of whatever kind and in whatever form paid," and the applicable Regulations specifically cover compensation paid in the form of a sale.

Accordingly, we submit that the *Palmer* case not only lends no support to respondent, but, on the contrary, its reasoning supports the Government's position here. The indispensable finding of intention which was lacking in the *Palmer* case is present here, and the breadth of the statute and Regulations applicable in this case is in contrast to the narrow definition involved in the *Palmer* case.

CONCLUSION

The decision below is erroneous and should be reversed.

Respectfully submitted.

CHARLES FAHY,
Solicitor General,
SAMUEL O. CLARK, JR.,
Assistant Attorney General,
SEWALL KEY,
J. LOUIS MONARCH,
Special Assistants to the Attorney General.

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